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The Changing Role of the State

Institutional Dimensions

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The quality — not the size — of the state is what counts. And a prerequisite for changing the role of the state is an improved political process. Without that, any new development strategy will fail.

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Most countries struggling to achieve economic growth and broader development objectives in the last 10 years have changed their strategies to incorporate two basic thrusts: a consistent macroeconomic and sectoral policy framework and a diminished role for the public sector, with more reliance on the private sector.

Israel emphasizes four points in this paper:

First, the argument that the size of the public sector must be drastically reduced has probably been taken too far, with no real analysis of the full consequences of the shift. Often the dismantling of some functions implies the establishment of others. (The existence of a competitive market is more important than private ownership.)

Second, a prerequisite for successful development of the private sector is a modernized, highly efficient public sector — particularly in key areas of policy management and regulation. The quality of the state is at issue, not its size. That quality depends on the state's being able to do at least five things in economic management:

- Design, monitor, and implement consistent macroeconomic and sectoral policies.
- Provide an enabling environment for competition, private or public.
- Privatize wisely and effectively.
- Conduct an effective dialogue with the private sector.
- Operate the remaining public enterprises more effectively.

To do each of these things, government will need fewer mid-level employees and more high-level professionals.

Third, the number of activities the public sector can safely and effectively undertake is limited. To force additional functions on the public sector increases exponentially the chances of failure and poor performance.

Fourth, a prerequisite for changing development strategy is a more effective *political* process. Seldom mentioned, this point is crucial — otherwise the new development strategy will fail. Ingredients of a more effective political process include a long-term perspective in policy design; a minimum level of stability in policy; a low level of corruption; and a general sense that political control does not necessarily imply public ownership or operation. These points are widely accepted in principle but not in practice, says Israel.

THE CHANGING ROLE OF THE STATE: INSTITUTIONAL DIMENSIONS

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THE CHANGING ROLE OF THE STATE: INSTITUTIONAL DIMENSIONS[1]

I. Introduction

A crucial development in the last decade has been the change in the strategy being pursued by most countries for achieving economic growth and broader developmental objectives. The essential elements of this strategy are, first, the preponderance given to a consistent policy framework both at the macro and sectoral level and, second, a changed (usually diminished) role for the public sector and a greater reliance on the private sector.

The universality of acceptance of the need to change the role of the state is remarkable. It is being pursued, in different degrees, by most countries irrespective of ideology, political structures or levels of development. Nor does it seem to be related to secular trends regarding the size of the public sector at different stages of development. A worldwide consensus has emerged about the limits of what can be achieved by public sectors, the failure of centralized planning, the need to relieve the public sector of a number of functions for which it has proved to be particularly unsuitable, and about the need to look for other alternatives in the private sector or among nongovernmental organizations to pursue a number of development objectives. In fact, this consensus is now sufficiently strong that at times it has been able to overcome strong resistance from powerful political and economic interests.

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[1] The author thanks his colleagues Brian Levy, John Nellis, and Mary Shirley for their excellent comments and contributions to this paper.

Much has been written about the reasons for this changing strategy.[2] First, there are technical reasons. The increasing complexity and international integration of economies--at all levels of development--has made it practically impossible to operate in an overly centralized manner, either in terms of planning or of public sector ownership. Second, public sectors, particularly in developing countries, just have not had the managerial and administrative capabilities for carrying out all the functions expected from an interventionist state, continue to be heavily involved in the production of a large number of goods and services and in addition, for trying to fine tune the economy by conscious "positive distortions" aimed at correcting market failures, providing incentives to certain activities or regions, discouraging others, and achieving a large number of other specific social or political purposes. Third, the many functions, operations, and corrections which the state undertakes give openings for all types of political interventions, often resulting in consequences diametrically different from those originally intended by the politicians. This is often due to the confusion in which the activities of the public sector are often undertaken and to the inefficiency of the political process itself. Not to mention, of course, the many opportunities for private "rent seeking" emanating from such situations.

For all the consensus of the need to change, there continues to be substantial controversy as to the appropriate role of a reformed state. At

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[2] See, for example, World Bank, World Development Report 1988. Oxford University Press.

one end of the spectrum are proponents of an entirely laissez faire state; at the other end are those who maintain that the state has an active promotional role even in private-led development strategies. This paper will not take sides in the debate over laissez-faire versus promotion. Rather, its starting point is that a fast dismantling of the state is inadequate as a policy prescription, even for laissez-faire strategies, and very little serious thinking has taken place regarding the "specific" implications for the public sector of the new development strategies. The purpose of this paper is to briefly begin to develop the following points:

1. The argument that the size of the public sector needs to be drastically reduced has probably been taken too far, without really analyzing the full consequences of the shift. Often the dismantling of some functions implies the establishment of others.

2. A crucial prerequisite for the successful development of the private sector is the existence of a modernized and highly efficient public sector, particularly in a number of key areas of policy management and regulation. <u>The issue is the quality, not the size of the state</u>.

3. At the same time, the number of activities that the public sector can safely and effectively undertake is quite limited.[3] To force additional

[3] For empirical evidence on the adverse effects of large governments, see Bela Balassa, "Public Finance and Economic Development". World Bank, PPR, Working Paper No. 31.

functions on the public sector increases exponentially the chances of failure and poor performance.

4. The change in development strategy also requires as a prerequisite a modernization and an improved performance of the political process. This point is seldom mentioned but it is crucial; otherwise, the new development strategy will fail.

The analysis has the Latin American reality as background, but is based on the broader experience of the World Bank in this area. The tone of the paper is normative; its purpose is to highlight the importance of the four points stated above.

II. Has the Pendulum Swung Too Far?

Much has been written and discussed about the role of the state from philosophical, political and economic points of views. Interesting arguments have been developed to help define the functions that should belong to the public and to the private sectors. However, we are not interested in those debates in this paper. Our purpose is to explore what a more private sector-oriented strategy means in terms of the specific roles that should be played by the public sector. For these purposes, it is sufficient to accept the conventional wisdom regarding the role of the state. This is summarized in the World Bank's World Development Report (WDR) of 1988. The report states that a pragmatic approach, balancing the arguments of both the public interest and private interest views and concentrating on the benefits and costs of government intervention, is the most useful way of looking at this issue.[4] Of course, the results will vary considerably from country to country, depending on their political and institutional capabilities to manage those interventions. The WDR ranks areas of economic activity according to the level of desirability of government interventions, based on criteria such as the promotion of economic efficiency and growth, poverty alleviation and stabilization. The report's proposed ranking lists as first priority public goods such as "defense, diplomacy, macroeconomic management, and a legal and institutional system that defines and enforces the rules of justice, property and commerce" (WDR 88, p. 52). It ranks second priority the need for governments to help in the provision of what it calls the social, physical and information infrastructure, including activities such education, health, transport networks, public utilities, technology development and dissemination and environmental protection.

Beyond these areas where market imperfections make it difficult for the private sector to produce the needed goods and services, the report postulates that the costs of government intervention outweigh the potential benefits in most of the productive activities in agriculture, industry,

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[4] The WDR 88 summarizes the position of the public and private interest groups as follows: "The public interest view stresses the potential benefits of government intervention when it is effectively deployed to correct market failures. It also provides a framework for identifying the conditions under which market failure is likely to occur and for designing the appropriate policies to offset these failures. The private interest view emphasizes the potential for failure and cautions against an overly sanguine view of government as the impartial guardian of the public interest." World Bank, World Development Report 1988, page 51.

energy, mining, and most of the services, particularly the financial services.

It should be noted, however, that the second category of areas in which government intervention is justified leaves the subject wide open. A number of practical experiments and research are presently focussed on the exploration of the private provision of such types of services.[5] Another perhaps more practical way of looking at this issue is to consider as a direct government responsibility the need to ensure the provision of the goods and services in that second category, whether through regulation of the private or by direct intervention of the public sector.

However, this scheme, now widely accepted, is biased towards private sector solutions. First, experience suggests that the issue of ownership, although important and a major determinant of economic performance, might not always be the most important. Often, the main issue is the existence of a competitive market rather than private ownership. In theory, if there is a competitive market, a public sector agency operating in that market <u>that is actually allowed fully to behave as a competitive unit</u>, is likely to have a level of operational performance similar to a private sector unit operating in that same market. The issue of course, is whether governments can muster the political will to give that level of freedom. Remarkably, there are not many technical studies that directly compare performance of the same activities operating in the private and public sectors and most of those available are

[5] See, for example, Gabriel Roth, <u>The Private Provision of Public Services in Developing Countries</u>. Oxford University Press, 1987.

very partial. One study concludes that: "There is no evidence of a statistically satisfactory kind to suggest that public enterprises in LDCs have a lower level of technical efficiency than private firms operating at the same scale of operation. (But) on a less formal level the tendency... seems to be pointing in that direction."[6] Other more partial studies, of industrial and manufacturing public enterprises and private operators in jute and textile in Bangladesh also found no clear evidence of private sector superiority.[7] The studies made in developed countries about the relative performance of public and private electric power companies are inconclusive in this respect. Also, although no conclusive studies have been made, it seems that at least in developed countries, the operational performance of a number of competitive state-owned industrial enterprises--for example, in Western European countries--is not noticeably different from similar enterprises in the private sector.

One can still postulate that ownership matters and that private sector units will be more efficient. It is likely, but the difference in some cases might not be that significant. More importantly, it might not be

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[6] For surveys of the literature comparing the performance of public and private enterprises in the same industries, see R. Milward, "Measured Sources of Inefficiency in the Performance of Public and Private Enterprises in LDCs", in Paul Cook and Colin Kirkpatrick (eds.) Privatization in Less Developed Countries. New York: St. Martins Press, and S. Domberger and J. Piggott, "Privatization Policies and Public Enterprises: A Survey", Economic Record, 62, 1986. Also Bela Balassa, "Public Enterprises in Developing Countries: Issues of Privatization" in Public Finance and Performance of Enterprises, Detroit, Michigan: Wayne University Press, 1989.

[7] John Nellis and Sunita Kikeri: "Public Enterprise Reform: Privatization and the World Bank". World Development, Vol. 17, No. 5, 1989, Page 664.

worthwhile for governments to use their scarce political capital fighting to privatize an activity to achieve only minor gains in efficiency.[8] Rather, that capital should be used to expand the ambit of competitive markets. More of this below.

The second count has to do with the intrinsic nature of the activities themselves. Most discussions about the role of the state usually take place in general terms, without exploring sectoral or subsectoral differences. The argument here is that the intrinsic nature and technological basis of an activity is a central determinant of performance. Many units in the "hard" sectors and subsectors, such as industry, telecommunications, electric power, have been able to maintain in the public sector a minimum level of operational effectiveness, even under extremely unfavorable general economic conditions. This has been so largely because the hard technologies impose an operational discipline that "soft" activities such as education, the provision of many services in agriculture and health, most of the activities in rural areas, especially at lower levels of development, and most of the activities of the central government do not have. What the "hard" activities have is specificity, the possibility of defining objectives and outcomes, and of tracing those outcomes in the short run.

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[8] One could ask a follow-up question: what purpose does it serve to have such a productive unit in the public sector, except as a source of political power. By definition, more of the government's political and social objectives could not be imposed on such a unit; otherwise they cannot operate as competitive units.

The experience of developing countries contains many examples of this phenomenon. Even in Sub-Saharan Africa, where the performance of the public sector is especially poor, there are a number of examples of "hard" public sector agencies or enterprises that have managed to survive, and even to thrive. Examples such as the Ethiopian Airlines, the power companies in Tanzania and Ghana and, until recently, the Kenya Tea Development Authority have been cited in this respect. Studies of these cases note that these units were able to attract relatively high caliber staff which helped to generate a political power base of its own, thus allowing these agencies to be relatively immune from excessive political intervention, especially as regards staffing, and ensured a minimum level of financial support.[9] A number of other similar examples can be quoted for Latin America and Africa, at least until the acute economic crisis resulted in a financial deterioration of these units, followed by an inevitable technical deterioration.

Conversely, there are "soft" activities, principally in the so-called social sectors, for which there is little discipline imposed by the underlying technology and intrinsic characteristics of the activity; they are not "specific" enough. If, in addition, these activities or sectors operate under monopolistic conditions, without profiting from the discipline imposed by competitive markets, and without their own source of income, their chance of operating effectively in the public sector are very slim indeed. Here ownership (or, more precisely in this area, the possibility of failure and

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[9] See A. Israel, Institutional Development: Incentives to Performance. Johns Hopkins University Press, Baltimore, 1987.

closure according to market rules) and exposing the activity to a competitive environment are crucial for achieving a higher level of operational performance. Classical cases in this respect are agricultural marketing boards, perennial losers in the hands of the public sector, education and health services, and other services in agriculture, such as input supply. It is in these activities that the largest gains from a more reduced role by the public sector can be achieved.

However, we should keep in mind that this agreement does not mean that "hard" public sector agencies or enterprises are performing well, especially in Sub-Saharan Africa; it only means that they are performing less badly than those in the "soft" activities.

Here we conclude with a paradox. If the two points raised above are right, then the relative gains of private sector operation are potentially higher in the second of the categories in WDR 88, that which contains the "merit" goods in which the role of the public sector is considered essential. Conversely, if a government brings itself to provide clear and depoliticized rules of the game for the state-owned enterprises in the hard sectors and to expand the ambit of competitive markets, then the urge and the benefits of privatizing those activities might be considerably reduced.[10] In short, the discussions on the role of the state should be disaggregated by sector or

[10] The last section of this paper deals with the political dimension, but an obvious counter-argument here is that public enterprises fail not because they are incapable theoretically of achieving efficiency, but rather because politicians are incapable of resisting interference, no matter how many safeguards are built into a system.

subsector, but the real potential for substantial improvements in efficiency in relative terms might be found in the private provision of public services in the social or "merit" sectors. Of course, large gains in efficiency in absolute terms might still be obtained by the privatization of "hard" activities in industry, energy and transport.

The third caveat, and perhaps the most important, is that a central ingredient of a development strategy based on a larger role for the private sector is a greatly modernized and higher quality public sector. This point has been made before. What has not been made is a systematic exploration of what it means. The section that follows contains an attempt in this respect.

III. The Quality of the State

What kind of reorientation is required in the public sector to adapt it to the new development strategies being pursued by most Latin American countries? Although such reorientation would be needed throughout the public sector, including its core or traditional activities (e.g., defense, police, diplomacy, infrastructure) the focus of this discussion is those changes that are required to promote economic and social development. This reorientation requires changes in a) the functions performed by the public sector; b) the administrative structures; c) the procedures followed, and d) the skills and management systems required.

Functions

The reorientation of the public sector with the new development strategies comprises a number of different functions that we cannot pretend to detail in this paper, but we wish to highlight the following five.

1. The capacity to design, monitor and implement a consistent set of macroeconomic and sectoral policies. A central ingredient of the new development strategies is a consistent set of macroeconomic and sectoral policies. Unfortunately, there is still no technique for estimating the economic and social returns of good policies, but it is a reasonable hypothesis that the return to good and consistent policies is the highest possible--Latin America's experience is littered with cases of bad and meandering policies, with glaring costs. A corollary is that the financial and institutional resources devoted to ensuring a high quality of policy management are probably those yielding the highest returns. It is difficult to think of a more productive use of resources.

While high quality policy management has a central political content (more on this in the next section) it also has heavy institutional and technical components. A preliminary analysis of the successful cases of policy formulation and implementation (France, UK, Korea, Chile, Mauritius, India, Botswana, etc.) suggests that there was in the key agencies (e.g., the ministry of finance, the central bank, the trade agencies, the main sectoral ministries) a number of highly qualified staff capable of analyzing policy options, of making decisions in a coordinated way among agencies, and of maintaining a reasonably effective communication with the political establishment, often being able to modify decisions on policy directions taken at the political level. Interestingly, the actual organizational structure of this group of agencies is not a major contributing factor to success. More important is the communication among the policy analysts and decision makers.

This capacity, which we may call the brain or nerve center of the government, need not be too large. It will vary from country to country, but we are probably talking of 30 to 200 persons, perhaps even less in some small countries. One thing is clear: if this capacity is not in place, basically nothing else works well. And the analogy with the brain is particularly relevant for a development strategy more reliant on market forces, which is meant to be more flexible and adaptable to changing circumstances. But this need for flexibility applies not only to the private sector; the same flexibility is required from the public sector, to adapt policies and policy management to those changing circumstances.

Thus, we wish to postulate that to have this central capacity for policy analysis and management at the macro and sectoral levels is the first priority in the reorientation of the role of the state, and governments should be willing to pay a very high price to have it. In Latin America, practically all countries do have the technical and managerial pool from which such a capacity could be drawn. None is in the dire situation of a number of countries in Sub-Saharan Africa, which do not actually have the necessary skills in the country. What often happens in Latin America is that those technical and managerial resources are not in the right place or, if they are, they might be hardly used or not used at all. Mechanisms have to be devised to attract and retain these skills to the right places, preferably within the rules under which the civil service operates. But if that is not possible, this might be the one case in which an exception ought to be made and it should be the duty of the political establishment to convince public opinion that it is necessary. What kind of exception depends on each country, but it usually implies a combination of pay, benefits and status that will put staff at a different level from the rest of the public administration. This has a heavy cost, but we postulate that the alternatives are even more costly. Also, some countries have been pursuing more extreme, or imaginative (or very old) solutions. Ghana has privatized part of the tax collection services and Indonesia has privatized the custom services. Other countries have relied heavily on consultants.

In a democratic system, this capacity for policy analysis and design need not be all in the public sector. In fact, it is healthy that part of that capacity is outside the government, in politically independent universities or think tanks.

In retrospect, it is remarkable that there is still not a full awareness of the crucial importance of this issue, even in a number of developed countries. But then, perhaps it is not surprising. The effects of good or bad policies are pervasive and it would be hard to trace them to an origin in policy analysis and design. But the magnitude and effects of the mistakes are there for everybody to see; what has to be impressed upon the political establishment is that those effects are the result of the work of a very small number of key people. Also, we should not forget that sometimes politicians might not be interested in having technical advice or they might, just ignore it. The impact of technocrats will grow only slowly, hopefully through an increasingly close interaction with the political establishment. In short, good advice is necessary, but it may not be sufficient, for good policy.

2. The capacity to provide a conducive enabling environment for the private and public sector activities that will operate in competitive environments. The provision of an enabling environment is a general label that comprises at least three main categories. The first is the dismantling of what we may call the disabling environment. At the policy level, this means the enactment of the liberalizing policies propounded in recent years, the privatization and liquidation of public sector activities which compete unfairly with private sector ones or are simply non-performing, and the elimination of restrictions on competition. However, policy changes are a necessary but not sufficient condition for success. Also required are legal changes and, perhaps more importantly, modifications in the functions of the state; i.e., many controlling and licensing functions have to be eliminated, for example, in foreign trade and foreign exchange controls, industrial and transport licensing, financial controls, etc.

Behind these functions there are public sector agencies performing them which have to be dismantled or reoriented. In practice, this has not been easy. In some countries, entrenched bureaucracies with considerable political power have managed to neutralize or greatly reduce the impact of policy reforms. The forces against change, including very specific financial benefits to some of the actors, have acted against the adoption or implementation of, for example, reforms to liberalize quantitative restrictions in countries as diverse as Kenya, the Philippines under Ferdinand Marcos, and Guinea. In other cases, powerful central leaders have managed to push for the policy changes in spite of bureaucratic opposition, and the old agencies have been left more or less intact but without a function to perform. Such a pattern was evident with Mexico's dismantling of quantitative restrictions over the objections of SECOFI, its Ministry of Trade and Industry, and with Tunisia's abolition of the requirement that prior to entry firms obtain clearance from API, the Agence des Promotion des Investissements. This is a dangerous situation, aside from the waste of resources involved, because those agencies can rebound or redirect their activities in unwanted directions. In a few cases, agencies have been quickly dismantled or reoriented to adapt them to the policy changes. The experience in developing countries or in Latin America as regards the evolution of these institutional adaptations has not yet been documented.[11]

[11] For an initial attempt to analyze these dimensions of reform, see Brian Levy, "The Impact of Public Institutions on Trade and Investment Policy Reform", PPR, The World Bank, October 1989.

Privatization and liquidation of public sector activities should also be considered a central ingredient in the elimination of the disabling environment. Many of the activities that should be privatized compete for resources and markets with private sector activities which could perform those activities more effectively.

The second aspect of the enabling environment requiring attention is the provision of a level playing field, that is, what is required to ensure an effective operation of the private sector and competitive markets. A key ingredient is the need to have a capacity for regulating non-competitive markets and a number of private sector activities. By regulation we mean not only the overseeing role required for the operation of competitive markets (e.g. antitrust, prevention of collusion or monopoly) but also the enforcement of financial and technical standards. Experience in developed and developing countries has shown that this is an essential function without which the new development strategies are unlikely to be successful or, in cases where regulations are inappropriate or nonexistent, the strategies will backfire.

Again, paradoxically, for the state to regulate effectively and wisely is extremely difficult; in fact, some people think that it might be even more difficult and likely to result in bigger mistakes than the state actually operating the activities being regulated. This, of course, is too extreme a view, but it highlights the risks of misguided regulation. As it is discussed below, the administrative and political requirements for effective regulation in terms of quality of the public sector are very high and will vary drastically among countries. It requires a high level of skills (for example, to monitor the banking system), high ethical standards and consistent political support, including a minimum of political interference. This does not mean, for example, that the government should own the banks. It means that special attention should be put on the way they are regulated.

The establishment of a level playing field also needs a clear set of rules and corresponding institutions that will permit the functioning of competitive markets and the private sector. Again, one might think that this refers to obvious activities that all public sectors perform almost automatically, but experience in Latin America and many other developing countries suggests that that is not the case. Many of the relevant functions have to be strengthened and others have to be created. For example, the enforcement of standards at the technical level, often a key ingredient for promoting exports; the streamlining of procedures to register property and protect property rights; the enforcement of contractual obligations and disclosure laws; effective bankruptcy and foreclosure proceedings. These, in a way, are the minimum requirements. Creating a level playing field also requires some form of regulation of externalities (for example, environmental protection) and establishing mechanisms to assure adequate information, and equal access to that information, on which to base market decisions, for consumers, producers, investors and regulators, through disclosure rules and other mechanisms.

The absence of such functions is an important contributing factor to the flourishing of the underground or informal sector, economic activities that have no alternative but to function outside the legal or formal economic system, with all the disadvantages that implies in terms of growth potential, access and cost of credit and workers' protection. Not to mention the potential activities that are simply not started because of reluctance to operate in the informal sector. The growth potential does not materialize, as has become evident time and again in a number of countries. In Latin America, the Peruvian experience has been extensively documented.[12]

Finally, the third aspect is a potentially promotional role on the part of the state, following a policy of creating "positive distortions" to promote emerging exports or particular groups of activities in the domestic economy. ome countries, particularly the Asian ones (Korea, Singapore, Taiwan) have been quite successful following this approach.[13] However, such an activist policy requires a delicate role on the part of the state, both

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[12] See Hernando de Soto, The Other Path: the Invisible Revolution in the Third World, New York: Harper and Row, 1989.

[13] For some useful contributions towards what is now a voluminous literature, see Alice Amsden, Asia's Next Giant: Late Industrialization in South Korea (New York, 1989); Robert Wade, Governing the Market: Economic Theory and the Role of Government in East Asia Industrialization (Princeton: Princeton University Press, (forthcoming); Tyler Biggs and Brian Levy, "Strategic Interventions and the political Economy of Industrial Policy in Developing Countries", in Dwight Perkins and Michael Roemer (eds.), Economic Systems Reform in Developing Countries (Harvard: 1990); and Larry E. Westphal, "Fostering Technological Mastery by Means of Selective Infant Industry Protection", in Moshe Syrquin and Simon Teitel (eds.) Trade, Stability, Technology and Equity in Latin America (Academic Press, 1982)."

intervene in the economy in order to achieve positive distortions requires, first of all, a political commitment to long term rather than short term objectives and a specialized and effective institutional capacity to design and implement the "distortion" policies and to monitor the economy--including the political effects--in order to fine tune or modify those policies.

This is a tall order for any country. The potential for mistakes is huge, and the effects of those mistakes will also be huge. In fact, even the best performers have made serious mistakes with this approach, for example, the support of heavy chemicals and heavy engineering in Korea. Before embarking with such policies, a country should make a hard assessment about its institutional capacity to implement such an approach, and the political will to push for it. Just attempting to create a level playing field might be, in theory, a second best, but it is hard enough as it is. Yet another possible paradox in this complex field is that countries that could profit more from a proactive development policy might be the least likely to succeed in implementing one.

3. <u>The capacity to privatize wisely and in an effective way</u>. Much more has been written and discussed about the concept of privatization than what it has been accomplished in financial and economic terms.[14] We do not want to

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[14] See, for example, S. Hanke, "The Privatization Option: An Economic Analysis", <u>Economic Impact</u>, 3, 1986; also G. Yarrow, "Does Ownership Matter?" in Cento Veljanovski, etc. <u>Privatization and Competition: A Market Prospectus</u>, Institute of Economic Affairs, Hobart Paperback 28, London, 1989. A research study financed by the World Bank is underway to analyze what has been the ex post impact of privatization.

add much to those pages; rather we just want to emphasize one point: that the state has a difficult role to play in the process of privatization, if this process is to be beneficial for the economy as a whole.

Aside from the political issues, an important factor slowing down the privatization process in many Latin American countries has been the lack of capacity in the public sector to prepare the units that are going to be privatized so that they can be sold (or leased, or any other form of partial privatization). Many need to be restructured or downsized, a highly technical undertaking for which few governments have the necessary capacity in the right places. Similarly, to prepare and negotiate a deal is also highly technical beginning, for example, with issues such as price and method of financing. True, such expertise can be bought from investment banks (at exorbitant cost) but the public sector still needs the capacity to negotiate with the bankers, which often is done very badly, to evaluate their work and to ensure that their recommendations and actions are in the public interest. To have this capacity does not imply a big organization but probably only a unit with a small number of highly qualified professionals with enough technical and political independence to do their job well. The Mexican experience is interesting in this respect. The extensive privatization process that has taken place has been "masterminded" by a three-man operation at the Ministry of Finance. This might not be enough in other cases with a less clear political mandate and does not include the need in some cases of restructuring public enterprises to prepare them for privatization.

Finally, the public sector needs the capacity to monitor and often regulate the privatized units to ensure that the expected efficiency gains from privatization will materialize. Again, this does not require a large contingent, but one that should be of high quality. Where to get this high quality staff is discussed below.

4. The capacity to conduct an effective dialogue with the private sector. An essential ingredient of the new development strategies is the existence of a better and more comprehensive dialogue between the public and the private sectors. This dialogue should be positively oriented towards exchange of information, demands, concerns, interests and points of view, and not negatively focussed on collusion and the negotiation of privileges on either side.

This is essential, but particularly culture-bound. Which form it should take will vary from country to country. What is important is that the dialogue has to take place at all levels, from "macro" to "micro". In most Latin American countries, many of the institutions required for this dialogue in both the private and public sectors have to be created or reoriented. With few exceptions, most public sectors do not have agencies attuned to this kind of dialogue, to look at the private sector as their client, with needs and preferences and with a voice that has to be taken into account. To an extent, this is a reflection that the previous planning and public sector-oriented strategies were almost by definition top down, with the public sector agencies seldom oriented towards a dialogue with the public or with potential beneficiaries, or to "demand" considerations. On the private sector side, there is an even wider disparity. At one extreme, the very small and powerless private sector operators including, by definition, the informal sector, are not grouped in any way that could make their views heard by government agencies. Individually, they often barely dare to approach any public sector agency, let alone try to influence them. How to organize a voice for this constituency will be a challenge in each country. At the other extreme, there are extremely powerful private sector associations (e.g., Chambers of Commerce) grouping the largest productive units which maintain a strong position vis a vis the public sector and have often managed to obtain important privileges. So much so that in some countries, it is thought that the private sector is really quasi-public (a first step in the privatization process should be to truly privatize the private sector). In this case, many of the public sector agencies dealing with these groups are relatively weaker and could easily yield to pressure. Nor does there exist much basis for a dialogue with regard to the middle ground, of middle size private sector or regional units. These might be represented in the large associations but with little control or voice in them.

Important institutional work is necessary in the private sector to prepare it for a productive dialogue with the state. Some of those large organizations need to be reoriented to widen their representation. New institutions will have to be established to give a voice to small and scattered operators. Non-governmental organizations might be quite suitable for this purpose, at least in the initial stages. But the essential ingredient for progress is a substantive political reorientation, from an excessive pursuit of privileges to a more open and constructive dialogue along the lines indicated above.

In the end, the specific nature of the dialogue between the public and private sectors in a specific country will be heavily influenced by the nature of the political processes in that country. In the Latin American context, the usefulness of explicit efforts to promote such a dialogue remains to be tested. Its effectiveness is heavily determined by deep social structural forces that are difficult to change in the short run.

5. The capacity to operate more effectively the enterprises that will remain in the public sector. No matter how drastic the switch to a private sector-oriented strategy, a good number of enterprises (not counting the central government operations) will remain in the public sector. Their performance will have to be improved dramatically for any development effort to succeed. Here, considerable progress has been made. In recent years, an approach has been developed to help governments set up clear rules of the game for public enterprises in terms of their policy framework, degree of autonomy and accountability. Promising results have been obtained. If more governments were to have the political will to undertake those reforms, the public enterprise problem could be substantially reduced.[15]

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[15] See Mary Shirley, The Reform of State-Owned Enterprises: Lessons from Work Bank Lending, The World Bank, June 1989.

We think that this set of five functions contains the essential capacities that need to be created or reinforced in light of the new development strategies. The pattern that emerges from reviewing these functions is the crucial importance of quality, of personnel in particular, in the performance of these functions. If anything, the leverage and impact of what the government does in a private sector-oriented strategy might be much bigger: a mistake by a public enterprise in producing a good or service has a negative impact, but sometimes a relatively limited one. A mistake made by a regulator could plunge a whole industry or sector into a crisis (no need to go beyond the U.S. to have examples of that); a sloppy monitoring of technical standards could thwart an export drive.

Structures

Beyond the sale and liquidation of state enterprises and the elimination of other public sector activities, the reorientation of public sector functions discussed in the previous section requires considerable changes not only in the actual organizational structure of the public sector, but also in the way the new functions ought to be managed. In other words, a "restructuring" of the public sector is necessary. At the level of the organizational structure, a number of agencies whose primary purpose is direct control of economic activities (e.g., industrial licensing, foreign exchange and import controls, price controls) will need to be eliminated or scaled down. However, new agencies or units within agencies will have to be created; for example, regulatory agencies (e.g., for the privatized financial sector, capital markets, technical standards) and agencies or units capable of undertaking policy analysis and management. Depending on the circumstances of each country, one can conceive of some regulations coming from the private sector itself. For example, the accounting and auditing professions, or the legal and medical professions may have sufficiently strong internal standards so that the role of the state in their regulation could be minimal.

These changes (not counting privatization) need not be massive relative to the total size of the public sector, but are crucial because they refer to the nerve or command center of the economy. Perhaps the best way to illustrate this point is to visualize those Latin American government agencies in charge of industrial licensing and pricing or foreign exchange controls, and what is expected to be a modern regulatory agency for the industrial sector. The former are traditional large agencies in which a high proportion of the staff is composed of relatively unskilled clerks slowly processing applications. The agency is supposedly managed and organized along traditional Weberian lines but, in practice, is open to heavy political control and in many countries is probably highly corrupt. In contrast, a regulatory agency operating along the lines described here ought to be a fairly small operation, staffed mainly with a few high quality professionals doing economic and technical analysis, and a team of highly specialized staff in charge of operating a data base. The old controlling agency is a classical, heavy bureaucracy; the new regulatory agency is closer to a think tank and should be managed as such. It does not sound good politically, but these new agencies should be elite units, to ensure the success of a private sector-oriented strategy. It behooves the political establishment, and the private sector in particular, to fully understand the importance of these new agencies and the delicate role that they are expected to play.

Procedures

As can be concluded from the previous sections, the reorientation under discussion should imply not only different functions and structures, but also different procedures. There are many worth discussing, but we wish to concentrate on two. The first and most difficult to modify stems from the fact, already raised, that the public sector cum planning orientation of past development strategies created, sometimes unwillingly, a heavy top down approach, in which government officials decided on policies and actions without really consulting the expected beneficiaries, or victims. This top down orientation resulted in an increasing distance between the public sector and the public in general, including the private sector. The new strategies just cannot be successful with such an approach. The dialogue between the public and private sectors, the "voice" of the stakeholders affected by the government policies and actions and the possibility of a bottom-up generation of those policies are indispensable ingredients. It is expected to be much more of a partnership and should function as such.

Many of the specific mechanisms for this more open approach are culture-bound, and the process is undoubtedly helped by a democratic political setting, but several measures could be borrowed from the experience of developed countries. For example, some countries have evolved procedures that permit prior comment on regulations or even policy changes by affected individuals or groups, making sure that this voice does not reflect only powerful vested interests. Other procedures have been designed to assure transparency in the design process of policies and regulations, to minimize the risk of collusion and corruption, to inform the public about decisions in language ordinary people can understand and, a crucial element, that permit the appeal by interested parties. The essence of the argument in this respect is that individuals and private enterprises are willing to take risks in part because they have a reasonable assurance that the state will act in a predictable, open and systematic fashion, treat them fairly, give them a voice and inform them of results. The less the private units are assured of this behavior, the higher the premium they will require to invest and operate and, as a consequence, the more difficult it will be for a particular country to promote a private sector-based strategy.

The second point is closely related. For the private sector to function, the points of contact between public sector agencies and individuals and private sector operators have to be much more efficient than what they are now and need to be greatly streamlined. By this we mean, for example, the whole system of tax collection, cf technical licensing and control, the issuance of exports or import permits (when still required), credit processing, etc.[16] This issue is so important that the failure of the public

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[16] Taking a broader perspective, some would add the provision of infrastructure services to this list.

sector to operate efficiently in these areas is given as much weight in explaining the existence of the informal sector as of distorted policies and cumbersome regulations. Perhaps many private sector units might have been able to live with unsatisfactory policies and regulations; what makes them practically impossible to live with is the appalling way in which they are applied.

Much can be done in this respect. It is a potential area of improvement which is highly technical, specific and which could show impressive results in a relatively short period of time. It is a way to focus administrative reform on the specific points of contact between the public sector--the bureaucracy--and the publics rather than on broad administrative reforms. There is positive experience on this in Latin America. For example, the de-bureaucratization program in Brazil has had an important measure of lasting success and other countries have followed that experience, albeit only partially.[17]

[17] See Helio Beltrao, "Debureacratization and Freedom", Brazil National Debureacratization Program, April 1982; processed.

Skills and Incentives

What these new functions, structures and procedures require are a different kind of civil servant and a changed set of incentives. The typical kind of staff that will become redundant is the middle level, clerical one that was involved in routine controlling and licensing functions. The kind that will become essential is the high level professional capable of working on policy analysis and design, on monitoring, on regulatory actions and on effective support to private sector activities. Many of this staff should have sufficient professional stature and integrity not only to dialogue with the private sector but also to withstand its financial and non-financial pressures. And, crucially, they should be able to dialogue with politicians. As indicated, this kind of staff is actually available in most Latin American countries, but often is not attracted or retained by the public sector. A different kind of pay and incentives system is required, sufficient to lure the right individuals to these key assignments. Some countries (e.g., Mexico, Brazil, Chile, Argentina) could achieve this objective with relative ease; some of these countries already have a sizeable proportion of the staff needed. What is required is perhaps a different set of incentives and a work atmosphere more conducive to the performance of the new functions.

Other countries have relatively less "stock" of the type of skills required and very few of these are in the public sector, to a large extent because of an inadequate system of remuneration and incentives. An unfavorable political climate leads highly skilled professionals to doubt the possibility of effectiveness in public sector assignments. The dilemma is how to attract them in the context of the unfavorable civil service policies prevailing in those countries. As indicated earlier, we think that these countries ought to take all the measures that are necessary to ensure a minimum level of the relevant staffing, even if it means working on an exception or enclave basis.

IV. The Quality of Politics

In discussions about the changed role of the state and the new development strategies, there is a topic about which little has been said. This, for want of a better name, we might call the quality, or effectiveness of the political process. And yet, I would assert that practically no country has been able to develop in a sustained way without a political system that functions with a minimum level of effectiveness and ethical standards, that is, with a minimum level of quality and stability. Some countries might have managed to have spurts of growth over fairly prolonged periods of time, but if the political establishment has not been able to modernize and adapt to that growth, the initial impulse will be lost because of political inefficiency. If those minimum conditions in the political process are not in place, no strategy is likely to produce sustained development.

What do we mean by the quality of politics? The first ingredient is a more "effective" political process. Nobody has defined exactly what this entails, but it surely includes elements such as a long-term perspective in policy design instead of a concentration on immediate gains; a minimum level of stability in the policy framework; a low level of corruption so that actual behavior is guided by policies and regulations and not by payoffs (thus making general behavior predictable); a general sense that political control does not necessarily imply public ownership or operation. These, I think, are widely accepted points in principle, but not in practice. But other aspects are equally or perhaps more important in the Latin American context. Politicians intervene excessively in the operations of the public and private sectors to the point where they often end up acting against their own political interests. This is because politicians act following a partial or short-term perspective. For example, price controls for public enterprises aimed at reducing inflation which result in higher inflation through the increased budget deficit (a higher inflation could end up hurting even more important constituents than those originally favored by price controls); political appointments of incompetent staff that bankrupt agencies that were the politicians' power centers; funding channeled to preferred regions that end up distorting resource allocation and damaging even the favored areas. Another way of making the same point is that there might be more effective ways to meet the (public and private) goals of politicians at lower cost to society and with higher benefits to the politicians themselves.

Equally important, the political establishment has to understand that to saddle agencies, central institutions or public enterprises, with an excessive number of often contradictory economic, political and social objectives makes their effective management practically impossible. To manage an activity with one clear objective is difficult enough. As the number of objectives increases, the potential for management failure increases exponentially. Over the last decades, politicians became used to and convinced of the legitimacy of intervening in all sorts of economic activities to correct market failures and to promote political, social or other objectives. There is a fairly elaborate theoretical basis in economics and in politics to justify those interventions.[18] But the massive bureaucratic failures in Latin America, exacerbated in the last decade by the economic crisis, have shown the impossibility of continuing with that degree of political intervention in the workings of the economic system. The fact is that such levels of attempted correction of the economic and political system are, literally, unmanageable. The result often has been stagnation or even decline, states in which none of the objectives--economic, social or political--are ever achieved. Everybody loses, including the politicians. A central ingredient of the new development strategies should be a more effective use of political power, based on a clear notion that the number of objectives that can be pursued simultaneously is small and that individual entities can be saddled with only a few of them. To have a sporting chance of being successful, political agendas have to be modest and objectives pursued preferably one by one.

A corollary to the previous discussion is the need for political and bureaucratic commitment at all levels of the public sector towards a different

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[18] For a recent summary of the causes of market failures, and an attempt to explain the bases of non-market failure as well, see Charles Wolf, Jr., Markets of Governments, Cambridge, Mass. M.I.T. Press, 1988.

role for the state along the lines discussed in this paper. One could hypothesize that this kind of development strategy requires an even greater commitment of state units at all levels, than a public sector-oriented one, because the relations between the public and private sectors will be more decentralized and more dependent on the decisions of a large number of officials. How to build up and sustain such a commitment is a big subject that needs to be explored.

What could be done to improve the quality of politics? Latin America should look for specific approaches beyond the obvious answers of improving the democratic process and the accountability of the political system. Strengthening the technocracy (inside and outside the government), particularly with regard to policy analysis, design and implementation, could provide not only the information necessary to improve the quality of political decision making, but also act as a <u>de facto</u> countervailing power, as it happens in many developed countries.

But more imaginative measures might be needed to change the entrenched habits of Latin American politicians. Why not training (although of course, it should never be presented like that to the politicians)? Many countries already have such programs, with different levels of success. There are several possibilities: seminars and conferences with universities and think tanks; exchanges and visits to countries with more advanced systems; seminars especially organized for parliamentarians; technical staff attached to individual politicians or groups of politicians. The problem is serious; the search for solutions is just beginning.

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